BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Order Instituting Rulemaking to Establish Policies and Rules to Ensure Reliable, Long-Term Supplies of Natural Gas to California.	Rulemaking 04-01-025 (Filed January 22, 2004)
Order Instituting Rulemaking to Require California Natural Gas and Electric Utilities to Preserve Interstate Pipeline Capacity to California.	Rulemaking 02-06-041 (Filed June 27, 2002)

REDACTED PUBLIC VERSION

OPENING BRIEF OF THE DIVISION OF RATEPAYER ADVOCATES REGARDING THE PETITION OF PACIFIC GAS AND ELECTRIC COMPANY FOR FURTHER MODIFICATION OF DECISION NO.04-01-047, FOR MODIFICATION OF DECISION NO. 05-10-015, AND REQUEST FOR EXPEDITED TREATMENT

I. INTRODUCTION AND RECOMMENDATIONS

Pursuant to Rule 75 of the California Public Utilities Commission ("Commission") and the directive of Administrative Law Judge Kim Malcolm, the Division of Ratepayer Advocates ("DRA") submits this Opening Brief regarding the Petition of Pacific Gas and Electric Company ("PG&E") for Further Modification of Decision ("D.") No. 04-01-047, for Modification of Decision No. 05-10-015 ("Petition"), and request for expedited treatment.

DRA opposes PG&E's request to incur hedging related costs of up to $xxx million[1] outside of its Core Procurement Incentive Mechanism ("CPIM").[2] This amount is in addition to the $xx million of hedges that were previously authorized by the Commission in D.05-10-015. If the Commission grants PG&E's request, PG&E could ultimately hedge up to an extraordinary total of $xxx million to cover a xxxxx-xxxxx winter period. This is xxxxxx xxxx xxxxx the $xx million in hedges that the Commission authorized in D.05-10-015 "[t]o provide much-needed supplemental protection from possible dramatic natural gas price increases in the wake of Hurricane Katrina and Rita…."[3]

PG&E's request is highly excessive, particularly in contrast to the $xx million in hedging authority for 2005-2006 granted in D.05-10-015. DRA continues to recommend that PG&E perform its hedging within the CPIM structure. However, if the Commission is inclined to grant PG&E's request to hedge entirely outside of its CPIM, DRA recommends the following modifications and requirements:

(1) PG&E's hedging budget for additional options for the winter of 2006-2007 should be capped at $xx million (excluding the $xx million previously authorized in D.05-10-015), resulting in a total hedging budget of $xx million;

(2) PG&E should not be allowed to hedge with xxxxx for the winter of 2006-2007, as proposed in its Petition;

(3) the xx percent hedging volume should be reduced to a more reasonable level;

(4) PG&E's lower CPIM tolerance band should be expanded to -2 percent; and

(5) the Commission should order PG&E to issue a report by April 1, 2007, that includes an ex post review, analysis, and documentation of how PG&E's hedging plan reduced or increased, and otherwise impacted gas costs for its customers.

[1] Petition of Pacific Gas and Electric Company for Further Modification of Decision No. 04-01-047, and for Modification of Decision No. 05-10-015, and Request for Expedited Treatment ("Petition"), Appendix B, p. 7.

[2] Petition, p. 2.

[3] Order Modifying Decision 04-01-047 in Response to the Petition of the Pacific Gas and Electric Company, Decision ("D.") 05-10-015, Ordering Paragraph 1, mimeo. at 25.

Finally, as a compromise to the diametrically opposite philosophies of hedging inside versus outside the CPIM, DRA proposes that the Commission adopt a "hybrid" approach, (with the modifications and requirements stated above) to allocate a portion equal to 25 percent of each hedge position inside the CPIM and the 75 percent remainder allocated outside the CPIM.

II. BACKGROUND

PG&E filed its Petition on May 5, 2006. As noted above, PG&E requests authority for hedging related costs of up to $xxx million outside of its CPIM. PG&E asserts:

> The requested modifications will allow PG&E to undertake hedging of its natural gas portfolio on behalf of core procurement customers for the winter of 2006-2007, outside of the CPIM. Prompt Commission action is needed in order to protect PG&E's core procurement customers from potentially severe natural gas price spikes in the coming winter.[4]

PG&E filed a somewhat similar petition last year following Hurricanes Katrina and Rita in September 2005, seeking to hedge outside of its CPIM. The Commission granted PG&E's request of $xx million for hedging for Winter 2005-2006, $xx million for Winter 2006-2007, and $xx million for Winter 2007-2008. The Commission, contrary to DRA's recommendations, authorized PG&E to incur and account for the $xx million in hedging costs outside of the CPIM. The impact of the $xx million of hedging for last winter was to increase last winter's average residential bill by approximately $2.00 (as recovered over a period beyond winter).[5] Pursuant to an ALJ inquiry, PG&E identified an ultimate cost of $xx million associated with its 2005-2006 hedging program, outside the CPIM with additional costs incurred within the CPIM. Last winter PG&E sought to hedge xxxx xxxx xxxx xxxxxxx. For this coming winter, PG&E seeks to hedge xxxx xxxx xxxx xxxxxxx xxx xxxxx.

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[4] Petition, p. 2.

[5] D.05-10-015, Finding of Fact 3, mimeo. at 24.

For Winter 2006-2007, PG&E seeks to spend up to $xx million for xxxx xxxxx[6] in addition to the $xx million previously authorized, totaling up to a staggering $xxx million. Further, PG&E has an xxxxxxxxxx product mix scheme in which it could put on xxxxx up to a dollar value of $xxx million. According to PG&E, its Monte Carlo analysis results indicate that there is a x% chance that the total hedging cost could go as high as $xxx million.[7] This would translate to an increase in the average residential bill over the coming winter of up to $xx[8] solely related to the execution of the proposed hedging plan. With an additional $x.xx associated with the $xx million previously authorized in D.05-10-015, the total average winter residential bill increase associated with PG&E's entire proposed hedging plan could amount to over $xx for residential customers.[9]

III. DISCUSSION

A. The Commission Should Not Authorize Hedging Costs Outside the CPIM.

PG&E claims that it "is proposing no changes to the CPIM itself, only that the hedging be performed and accounted for outside of CPIM."[10] This is mere semantics. PG&E's proposal to perform and account for hedging outside of its CPIM in fact would modify the CPIM mechanism itself.

Last year, PG&E came to the Commission in the aftermath of Hurricanes Katrina and Rita, seeking relief from the CPIM. In D.05-10-015, the Commission granted PG&E's request and thereby reduced PG&E's risk in the CPIM mechanism while maintaining the reward side of the CPIM equation status quo. In other words, the Commission implicitly altered the CPIM compact to lean more favorably towards PG&E.

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[6] Petition, Appendix B, p. 1.

[7] Petition, Appendix B, p. 7.

[8] *Id*.

[9] xxxxxxxxxxxxxxxxxxxxxxx

[10] Petition, p. 9.

Now, a year later, PG&E seeks to keep the modified CPIM in place for another year.[11] It is very important to highlight that the catastrophic effects of Hurricanes Katrina and Rita, which were the basis of allowing hedging outside the GCIM last year, do not exist currently. Absent such emergency situation, the Commission should not allow PG&E to hedge outside the GCIM.

PG&E acknowledges in its Petition that it is fully aware of both the increased possibility of hurricanes hitting the Gulf States and the overall devastation and disruption that they can cause. PG&E has had time to (a) plan for this coming winter, (b) plan for hurricanes of this magnitude, and (c) put appropriate hedges in place inside of the CPIM to counter precisely such eventualities. PG&E is also seeking retroactive recovery of costs and payouts associated with 2006-07 hedging xx xxx xxxx xx xxxx xxxxxx that it is already undertaking during the month of May 2006. PG&E seeks to move these hedges from inside its CPIM to outside its CPIM, i.e., transfer 100 percent of the associated risk with the hedges in place to ratepayers.

PG&E states that it has implemented the Commission-authorized hedging program successfully.[12] However, PG&E fails to define the ultimate results and impact on ratepayers of its 2005-2006 hedging program. In its response to the ALJ inquiry, PG&E did provide information regarding the current market value of the $xx million of hedges that were authorized in D.05-10-015. These instruments had an estimated value of approximately $xx million PG&E fails to provide any details regarding the ultimate benefits of the expenditures associated with the ultimate hedging costs for Winter 2005-2006 that were authorized in D.05-10-015.

In D.05-10-015, the Commission stated that "We want PG&E and other utilities to employ hedges to the extent they are likely to be beneficial to core customers."[13] However, D.05-10-015 did not impose any review of PG&E's hedging behavior

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[11] PG&E's recently submitted Application for Long-Term Core Hedging, Application ("A.") 06-05-007, seeks to eternalize this favorable treatment under the adulterated CPIM.

[12] Petition, p. 2.

[13] D.05-10-015, mimeo. at 3.

associated with its hedging plan. In its Petition, PG&E provides no information regarding how its 2005-2006 Gas Hedging Plan was beneficial to core customers. To DRA's knowledge, following the issuance of D.05-10-015, PG&E exercised its hedging authority in the extremely compressed time frame between xxxxxxx xxx xxxx xxx xxxxx xxx xxxx, in the aftermath of the hurricanes. There is no evidence that such hedging behavior helps reduce gas costs for PG&E's core customers. Indeed, such hedging behavior may likely serve to increase gas costs for PG&E's customers. PG&E also provides no evidence regarding how its current strategy and significant proposed hedging expenditure for 2006-2007 will benefit or provide optimal value to its customers. If PG&E cannot justify how the Commission authorized hedging in the winter of 2005-2006 benefited its core customers, then the Commission should not approve PG&E's Petition which allows PG&E to incur $xxx million in hedging costs outside the CPIM. This ultimate exposure is almost xxx times the amount the Commission authorized in the aftermath of two major events.

Should the Commission revert back to reasonableness reviews? DRA is not supportive of this approach, and PG&E seeks essentially pre-approval of its hedging request with continuation of the CPIM. However, xxx xxxxxxxxxx xx xxxxx xx x xxxxx xxxxxxx is somewhat inconsistent with the use of performance measurement based on the physical cash market employed in the CPIM. If PG&E is xxxx xx xxx xxxxx xx xxxxxxx xxxxx xxxxxx for a significant portion of the portfolio volume, then it raises an issue regarding generating a possible CPIM performance reward in the cash market for that identical volume of gas.

DRA, therefore, recommends that all of PG&E's hedging be performed within its CPIM. The Alternate Draft Decision of ALJ Weissman in response to PG&E's Emergency Gas Hedging PTM filed last year agreed with DRA that "there is nothing about the CPIM in its current form that would prohibit PG&E from using hedges to the extent it feels it needs to, in order to protect core customers."[14] The CPIM tolerance band

[14] Rulemaking 04-01-025, Alternate Draft Decision of ALJ Weissman, mailed Sept. 28, 2005, p. 16.

of 2 percent above the benchmark provides PG&E the ability to rely on it to a significant extent for purposes of shareholder risk protection for potential hedging transactions and losses. For example, the tolerance band for the CPIM period covering November 1, 2004 through October 31, 2005 (Year 12) was approximately $51.5 million. Since the tolerance band is based on 2 percent of commodity cost, and gas prices continue to remain high, the expectation would be for the tolerance band to also remain high, thus providing the necessary cushion for PG&E to hedge inside of its CPIM.

B. Any Authority to Hedge Outside the CPIM Should Have Limitations Imposed Relative to PG&E's Hedging Request.

As previously stated, PG&E has failed to provide evidence that its 2005-2006 Hedging Plan benefited core customers. There is no evidence that an expenditure that could possibly amount to almost xxxx times that amount as proposed by PG&E in its Petition will benefit ratepayers. Furthermore, PG&E provides no rationale or evidence in support of its product mix framework for Phase II Hedging set forth in Appendix B of the Petition. PG&E does not discuss how it arrived at such a strategy or how such a strategy will benefit or provide optimal value to core customers.

In D.05-10-015, the Commission "defer[ed] to PG&E's judgment that the protection these hedges provide far outweigh the costs."[15] To date, the Commission has not been presented with any evidence whether the hedge protection outweighed the hedge costs for the 2005-2006 winter hedging. Absent such evidence, the Commission should not defer all hedging decisions to PG&E unless it is performed within the CPIM. The Commission can only expect PG&E to optimize its risk-return combination when shareholders have a stake in the hedging strategy. At the very least, PG&E should be required to allocate some portion, equal to 25 percent, of each winter hedge position to the CPIM, subject to the conditions set forth below, with the remaining 75 percent of each hedge position being borne by ratepayers outside the CPIM.[16] This "hybrid"

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[15] D.05-10-015, mimeo. at 15.

approach will ensure that PG&E has the motivation and incentive to optimize its hedges, that PG&E properly manages its hedging strategy and activities and that PG&E has some stake in the success of its program.

In the event that the Commission grants PG&E's request of hedging outside of the CPIM, then DRA recommends the following:

1. PG&E's additional hedging budget for the winter of 2006-2007 should be capped at $xx million;

2. PG&E should not be allowed to xxxxx xxxx xxxxx;

3. The xx percent hedge volume should be reduced to a lower, more reasonable level;

4. PG&E's lower CPIM tolerance band should be expanded to -2 percent in consideration of the removal of hedging activities from the CPIM and the reduced risk to shareholders; and

5. The Commission should order PG&E to prepare a report which provides a review of how its hedging plan served to reduce or increase, and otherwise impacted gas costs for its customers.

C. PG&E's Requested Hedging Budget Is Excessive.

PG&E is seeking approval of a hedging budget amounting to (up to) a staggering $xx million xxx xxxx xxxxxxx plus another $xx million xx xxxxxx xxxx xxxxx xxxxxx xx xxxxx xxxxxxx for which PG&E's ratepayers could be liable. Additionally, there is a small, x percent chance that, based on current market expectations, PG&E's ratepayers could be out by even more than $xxx million.[17] This is in addition to the $xx.x million previously authorized in D.05-10-015 for the coming winter, for an aggregate of $xxx.x million in potential hedging costs for a xxxxx xxxxx winter period. In contrast to the $xx.x million that PG&E was authorized to spend on hedging last winter in the devastating aftermath of Hurricanes Katrina and Rita, PG&E's proposed budget is beyond excessive. The xxxx xxxxxxx xxxxxxxxxx xxx xxxxx alone for the hedge period

[16] This could be accomplished by simply allocating 25 percent of the net gains or losses associated with PG&E's hedging to the CPIM in the appropriate period.

[17] Petition, Appendix B, p. 7.

would amount to up to $xxx million or xxxxxx xxx level of hedging authorized in D.05-10-015.

According to PG&E, the potential $xxx million of hedging costs translates to a potential $xx winter bill increase per customer due to hedging alone.[18] This $xx potential increase is xx% relative to the estimated $270 average winter bill.[19] PG&E fails to justify its proposal to expose ratepayers to up to $xxx million in hedging costs and the related rate impacts, and the Petition does not explain the basis for this substantial level of expenditures. DRA is not opposed to PG&E hedging inside the CPIM, but is opposed to excessive level of hedging proposed outside the CPIM. The Commission should bear in mind that under PG&E's proposal, PG&E has absolutely no accountability and nothing at stake with regards to the performance of these hedges.

If the Commission decides to once again allow PG&E to hedge outside of the CPIM, then DRA recommends that PG&E's hedging budget for the 2006-2007 winter be capped at no more than what was authorized last year, i.e., $xx million. Since D.05-10-015 authorized PG&E to spend $xx million in hedging for the 2006-2007 winter already, this would leave an additional budget of $xx million to further hedge gas costs for xxxxxxxx xxxx through xxxxxxxx xxxx. Last year, PG&E's Emergency Hedging Petition was based on the specific, dire circumstances resulting from the catastrophic 2005 hurricane season. There is no basis or evidence provided by PG&E in its Petition to justify the $xxx million (of ratepayer exposure) being requested.

PG&E has had ample time to prepare for the possibility of another hurricane season under the CPIM compact. However, if the Commission does decide to authorize a hedging budget outside the CPIM for the upcoming winter, it should certainly not exceed the maximum budget of $xx million authorized last year, which results in incremental hedging authority of $xx million.

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[18] *Id*.

[19] Source: Risk Analysis of Proposed Hedge Strategy, April 21, 2006.

D. PG&E Should Not Be Authorized to xxxx xxxx xxxxx Outside the CPIM.

Depending on market prices at the time of executing the hedges, PG&E also plans on *** BEGIN PROPRIETARY

END PROPRIETARY ***

Another issue worthy of consideration is what would have been the outcome of a Phase 2 type strategy if it had been employed last October in lieu of xxx xxx xxx xxxx xxxxxxx. Under market conditions that existed when the Petition was filed, PG&E's xxxxxxxxxxx strategy will result in a product mix of xx percent xxxxxxx and xx percent xxxxx. The market conditions may be xxxxx xx xxxxxx xxxxxxxx xxx xxxxx xx xxxxxx in the product mix. However, if PG&E's hedging mix requires it to hedge xx percent in xxxx, then PG&E will ultimately have xxxxxx almost xxx, xxx MMBtu per day. If prices move down by, say, $4.00 per MMBtu, xxxxx xxx xxxx xxx xxx xxx xxx xx xxxxx xxx xxx xxxx xxx xxxx xxx xxxxxx, PG&E's ratepayers would suffer an enormous loss of $xxx million xxx xxxxx xxxxx, xxx xxxxxxxx xxxxxx xxxxx.

While xxxxx xxxxxxx xxx xxxxxxx xxxxxx, they expose PG&E's ratepayers to significant price risk. A factor contributing to that high potential risk is the large volume of gas being hedged at the xx percent level, which is the basis of total gas being hedged during the xxxxx winter months. Again, PG&E would have no incentive to minimize xxxx losses if the hedging risk is removed from the CPIM. DRA recommends that PG&E not be authorized xx xxx xxxx, unless PG&E finds them appropriate to use within the CPIM.

E. The Volume that PG&E Proposes to Hedge Is Excessive.

PG&E seeks to hedge xx percent of its average daily demand for the months of xxxxxxxx xxxx through xxxxxxx xxxx. PG&E seeks to use xxxxx xxx xxxxxx contracts with strike prices of $x.xx xxx-xx-xxx-xxxxx to accomplish its objective. While DRA agrees that the xxxxxxxx through xxxxxxxx time period is the appropriate period to hedge, xx percent is not the appropriate level. PG&E offers no justification for hedging xx percent of its average daily demand other than it is "consistent with a xx percent net open position operating threshold used in PG&E's electric portfolio, as referenced in CPUC Decision 03-12-062."[20] PG&E is allowing a xx percent net open position to allow for weather-driven load variability. Except for the xx percent open position, PG&E has proposed to hedge xxxxxxxx xxx of its xxxxxxx through xxxxxxx core load. While some hedging may be warranted, hedging xx percent is excessive and not supported by any evidence or analyses relevant to PG&E's gas procurement.

Under its proposal, PG&E has nothing to risk xxx xxxxxxx xxxxxx xxx xxxx xxxx xxxx, while ratepayers must bear 100 percent of the hedging costs for what is amounting to a very expensive insurance policy. Since PG&E's proposal places winter hedging outside of the CPIM, there is no incentive whatsoever to minimize the "insurance costs."

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[20] Petition, Appendix B, p. 2.

The fact is that hedging, like insurance, can be expensive. And one can over-hedge just as one can over-insure. Spending up to $xx[21] for hedging on an average winter bill of $270 for an average customer is over-hedging.

DRA is concerned that PG&E's hedging goal of xx percent is based entirely on the premise that it is done on the electric side. PG&E offers no analysis as evidence to show that the xx percent has been beneficial for ratepayers on the electric side. Now, PG&E offers no analysis to support that the xx percent is the optimal volume to hedge for gas procurement. If the Commission is going to allow PG&E to hedge outside the CPIM, then the volumes should be reduced. DRA emphasizes its concern regarding the combination of a strategy that allows for a product mix of xxx xx xxx xxxxxxxxxxx xxxx xxxx xxxxxx in conjunction with up to xx percent of winter volumes being hedged could be ultimately more risky than the so-called gas market volatility risk which PG&E is hedging against. PG&E offers no analyses or evidence to show that the benefit associated with its hedging strategy outweighs the significant cost and risk. If the Commission is inclined to allow the product mix framework set forth by PG&E and not adopt a reduced budget, then it must reduce the xx percent volume figure. An alternative for consideration is to allow PG&E to hedge a smaller volume of winter gas equal to the difference between the average annual core demand and the xxxxxxxx xx xxxxxxxx volumes, which amounts to hedging a volume of approximately xx percent of its xxxxxxxx xx xxxxxxxx demand.

F. PG&E Should Not Be Authorized to Hedge Storage Injection Gas Outside the CPIM.

In addition to the winter hedging, PG&E proposes to hedge up to an average of xxxxxxx MMBtu per day of gas that PG&E will buy for injection into storage in xxxx through xxxxxxx xxxx. PG&E core ratepayers already pay over $40 million in storage

[21] See page 4 and footnote 9, above.

reservation costs for the ability to inject 33.5 Bcf of gas into storage for withdrawal in the winter.[22] Storage gas not only provides winter reliability benefits for the core, but also serves as a physical gas hedge, allowing the core to buy gas at lower prices during the non-winter months, for use during the higher-priced winter months. Storage is a hedge and PG&E's proposal to "hedge the hedge" is unnecessary and again serves to increase costs for the core. Again, PG&E provides no compelling rationale to support this non-winter hedging and fails to show how and why employing such hedges is likely to benefit core customers. There is no basis to remove this non-winter purchase function out of the CPIM. If PG&E thinks that hedging storage injections is beneficial, then it should perform this activity within the CPIM compact and share in the associated risk. Otherwise, the Commission should not authorize non-winter hedging costs outside of the CPIM.

IV. CONCLUSION

DRA recommends that PG&E's hedging should be performed inside of its CPIM to ensure that PG&E has the appropriate incentive to optimize and manage its hedges, rather than merely buying over-priced insurance irrespective of cost. By doing so, the Commission will maintain PG&E's CPIM compact in its appropriate form.

In the event that the Commission finds merit in PG&E's performing hedging activities outside of its CPIM, DRA recommends the following:

1. PG&E's hedging budget for options should be capped at a total of $xx million, including the $xx million authorized in D.05-10-015 for the 2006/2007 winter. This would require authorization of an additional $xx million by the Commission;
2. PG&E should not be allowed to xxxxx xxxx xxxxx;
3. The xx percent volume that PG&E proposes to hedge should be reduced;
4. PG&E's lower CPIM tolerance band should be expanded to -2 percent;

[22] In A.05-03-001, which is pending a Commission decision, DRA entered into a settlement agreement with PG&E to allow for increased storage for the core.

5. The Commission should order PG&E to provide a detailed report, including a thorough review and description, of how PG&E's hedging plan reduced or increased gas costs for and otherwise impacted its customers; and
6. An allocation of 25 percent of each hedge position inside the CPIM and the remaining 75 percent outside the CPIM as a compromise to the diametrically opposite notions of hedging 100 percent within versus 100 percent outside the CPIM.

Respectfully submitted,

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August 3, 2006

CERTIFICATE OF SERVICE

I hereby certify that I have this day served a copy of "**REDACTED PUBLIC VERSION** **OPENING BRIEF OF THE DIVISION OF RATEPAYER ADVOCATES REGARDING THE PETITION OF PACIFIC GAS AND ELECTRIC COMPANY FOR FURTHER MODIFICATION OF DECISION NO.04-01-047, FOR MODIFICATION OF DECISION NO. 05-10-015, AND REQUEST FOR EXPEDITED TREATMENT"** in **Rulemaking 04-01-25** and **Rulemaking 02-06-041** by using the following service:

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Executed on August 3, 2006 at San Francisco, California.

/s/ NELLY SARMIENTO

NELLY SARMIENTO

N O T I C E

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